May 27, 1998

The Honorable Marsha Pyle Martin
Chairman and Chief Executive Officer
Farm Credit Administration
McLean, Virginia

Dear Ms. Martin:

We have completed our evaluation of the Farm Credit Administration's (FCA or Agency) use of enforcement actions. The objectives of this audit were to (1) evaluate FCA's use of enforcement actions in obtaining corrective actions in Farm Credit System institutions; and, (2) document and evaluate FCA's current organizational structure and process as it pertains to achieving enforcement objectives.

The Agency's enforcement actions have, for the most part, been effective. Our review identified opportunities to enhance the timeliness and efficiency of enforcement actions by: eliminating the use of supervisory letters as enforcement documents; establishing due dates for completing key steps in enforcement actions; establishing formal criteria for terminating enforcement actions and returning the institution to a normal level of supervision; and reviewing reporting requirements imposed on institutions under enforcement actions for duplicative or nonessential aspects. The transfer of the enforcement function from the former Office of Policy Development and Risk Control to the Office of Examination addresses the need to streamline the Agency's organization of enforcement activities. Increased delegations of enforcement authority by the Board may further improve timeliness and efficiency of enforcement actions taken.

This audit was conducted in accordance with Government Auditing Standards issued by the Comptroller General for audits of Federal organizations, programs, activities, and functions. Fieldwork was conducted from November 1997 to January 1998 at FCA headquarters in McLean, Virginia. An entrance conference was held on November 25, 1997. A draft of this report was provided to management on March 25, 1998 and, based on a report conference with management, revised and reissued on April 30, 1998. Their written response is included in this report.

Respectfully,

Eldon W. Stoehr
Inspector General

Table of Contents

OBJECTIVES, SCOPE AND METHODOLOGY

The objectives of this audit were to: (1) evaluate the Farm Credit Administration's (FCA or Agency) use of enforcement actions in obtaining corrective actions in Farm Credit System (System) institutions, and (2) document and evaluate FCA's current organizational structure and process as it pertains to achieving enforcement objectives.

We reviewed selected enforcement action activity taken by the Agency from January 1, 1990 to September 30, 1997. We reviewed the case files for those institutions with enforcement actions in place for more than five years and reviewed a sample of actions proposing conditions of mergers or reorganizations taken during each fiscal year. We also reviewed Agency policy and procedures guiding the use of enforcement actions.

We documented the Agency's organization and practices for enforcement activity and surveyed five other Federal financial regulatory agencies' characteristics and guidelines for enforcement actions. The survey was conducted through telephone interviews with individuals in those agencies who were either directly involved in or knowledgeable about their respective agency's enforcement action process. In addition, we interviewed Agency staff involved in the enforcement process.

BACKGROUND

The FCA is an independent Federal financial regulatory agency of the United States government with regulatory, examination, and supervisory responsibilities for the System banks, associations, and related institutions that are chartered under the Farm Credit Act of 1971, as amended (Act).

FCA derives its enforcement authority from the 1985 Amendments to Title V, Part C, of the Act, (12 U.S.C. Section 2261 et seq.) which grants the Agency certain enforcement powers for the purpose of effecting corrective action in System institutions. It is FCA's practice that institutions requiring "more than normal supervision" be considered for enforcement action. Generally, "more than normal supervision" is given to System institutions which: (1) are assigned a Farm Credit Administration Rating System composite rating of 3, 4, or 5; (2) exhibit individual characteristics that pose excessive risk to the institution regardless of its composite rating; and/or (3) may require punitive action to effect correction. This special supervision has included supervisory letters, supervisory conditions of merger or corporate restructuring, written agreements, cease and desist orders, and civil money penalties. The Agency also has the authority to remove officers; however, this authority has not yet been used.

FINDINGS, CONCLUSIONS AND RECOMMENDATIONS

<u>FCA's Enforcement Actions Have Generally Been Effective. However, Opportunities Exist to Enhance the Timeliness and Efficiency of Enforcement Actions.</u>

Recommendation No. 1: The Agency should eliminate the use of supervisory letters as enforcement documents.

The Agency should make a clear distinction between supervisory correspondence and enforcement documents. During the review period, supervisory letters were commonly considered enforcement documents even though they are, in fact, a warning or supervisory direction and not enforceable. Sixty-nine percent (233 out of 337) of all "enforcement actions" taken (as defined by Agency enforcement statistics) during the period reviewed were supervisory letters. Most supervisory letters we reviewed were essentially a restatement of actions requested in the report of examination. The process for deciding to send a supervisory letter primarily involved Office of Examination (OE) and the Office of Policy Development and Risk Control (OPDRC) without review or approval by the FCA Board.

Notwithstanding the absence of legal enforceability, there was a deliberate Regulatory Enforcement Committee (REC) strategy to use supervisory letters as warnings and to exert pressure on institutions to correct weaknesses identified in reports of examination. We think the use of supervisory letters as enforcement documents does not properly distinguish between the separate supervision and enforcement responsibilities of the Agency and may dilute the impact of the report of examination.

We believe the supervisory benefits that may have accrued from the previous use of supervisory letters can be obtained more efficiently within the examination process. When an examination identifies supervisory concerns, the examination report transmittal letter can communicate a warning, and the gravity of Agency concerns could be underscored by having higher ranking OE officials present such reports; i.e., the field office director or the Chief Examiner.

Recommendation No. 2: Criteria should be established for determining when termination of enforcement actions should occur and institutions returned to a normal level of supervision.

Some articles in enforcement documents, designed to improve a condition, lacked appropriate focus or specificity. In some instances, the goal to be achieved was imprecise or ambiguous. "Full compliance" with the articles in the enforcement document did not always eliminate the conditions which caused the enforcement action nor was the action always terminated when full compliance was documented.

Our discussions with staff in the Risk Control Division (RCD) disclosed an informal target that institutions under enforcement action should improve sufficiently to permit the enforcement action to be lifted within three years. The majority of enforcement actions were, in fact, removed within the three-year period; however, there were several instances in which the Agency found insufficient improvement to support removal of the action within that time. Sometimes one enforcement document was lifted but was replaced with another document. We also found five individual enforcement documents, which were in effect for in excess of five years. In those cases, subsequent examinations identified new concerns which the institutions were required to resolve before the document was lifted, even though there was "full compliance" with the articles of the original enforcement document for a prolonged period of time. Documentation in the enforcement files evidenced frustration and confusion by System officials over this situation.

We believe the lessons learned through past enforcement experiences should equip Agency staff to now establish specific criteria to identify the conditions for lifting an enforcement document. Performance measures developed for FCA's enforcement activities should integrate the objectives and criteria for placing and lifting enforcement documents.

Recommendation No. 3: The Agency should review its reporting requirements for institutions under enforcement actions and eliminate any that are duplicative or non-essential.

Some enforcement actions imposed burdensome reporting requirements. The Agency's enforcement practices have steadily evolved over the past decade; nevertheless, we noted numerous instances in which enforcement documents required initial copies and continuing reporting to both the Director of the respective OE field office and the Director of the RCD. This practice is not only burdensome to institutions but also contributes to an inefficient use of Agency resources through the redundant processing and reviewing by two or more, separate FCA organizations. We did note instances in which reporting requirements were reduced, but only after institutions complained or requested relief--not because of Agency monitoring or assessment of information needs. As a general rule, internal FCA distribution should be an Agency responsibility.

The Organizational Structure and Practices of FCA's Enforcement Activities.

The enforcement practices reviewed during this audit were performed under the joint administration practices of OE and the OPDRC. The OE and the OPDRC/RCD were jointly responsible for regulatory oversight of institutions under enforcement action. OE had responsibility for examining and monitoring the performance and condition of all System institutions, while the RCD was responsible for oversight of institutions operating under enforcement documents.

Enforcement actions were initiated by findings of an OE examination or through monitoring activities. When these activities identified conditions in institutions calling for "more than normal supervision," OE would recommend an enforcement action, supported by a Supervisory Action and Monitoring (SAM) form which detailed the basis for the enforcement action and recommended specific articles for inclusion in the document. The report of examination transmittal letter to the institution normally included a comment that the report had been forwarded to the OPDRC for consideration of enforcement action.

OPDRC staff would then perform an independent evaluation of the basis and appropriateness of OE's enforcement recommendation and draft an enforcement document, usually by tailoring model articles developed to correct similar deficiencies in other System institutions. The OPDRC draft action (with supporting documents) would then be forwarded to the Regulatory Enforcement Division (RED) of the Office of General Counsel (OGC) for legal review. The draft action (amended as appropriate) would then be forwarded to the responsible OE field office for any further input. The draft action was then submitted to the REC comprised of the Director of OE, Director of OPDRC (Chairman), and the Agency's General Counsel. The REC deliberations included non-voting participation from the Director of the RCD, Associate General Counsel of OGC's RED and the Official for Risk Management of the Farm Credit System Insurance Corporation. The REC would review the draft action, make revisions as appropriate, and then forward the recommended action to the Board. Upon Board approval, staff would be delegated appropriate authority to negotiate and execute the document with the System institution.

The recent transfer of enforcement responsibilities between the former OPDRC and OE has improved the organizational structure and process related to the Agency's use of enforcement actions.

Subsequent to the December 19, 1997 FCA Board action which transferred enforcement responsibility from OPDRC to OE, the Special Examination and Supervision Division within OE assumed the duties previously performed by the OPDRC/RCD. The OE Director now chairs the REC. In addition, OE field offices now prepare a new document called the Recommendation for Enforcement Action Memorandum that replaces the SAM and a portion of the evaluation previously drafted by the enforcement examiner. OE is currently developing procedures to reflect these organizational and procedural changes.

Our review of the Agency's former structure and process identified streamlining opportunities. These opportunities became more evident through our benchmarking of other regulators, which had also organized enforcement functions similar to the recent FCA Board action. The recent actions taken by the Agency have addressed several of the opportunities to eliminate redundant activities and make the process more efficient. Other regulators have also delegated some authority to take enforcement actions, primarily for actions of a remedial nature. However, some regulators have also delegated authority for imposition of civil money penalties and removal of officers. Currently, the FCA Board approves all enforcement actions.

The Board may wish to delegate authority for some enforcement actions.

The involvement of the Board in enforcement actions increases the time needed to place an institution under enforcement. The average time from the exit conference date of the examination until the placement of the action was over five months (160 days) for the sample of actions we reviewed, with a range of 90 days to 254 days. The average for the last ten actions showed an improvement as the average was lowered to 133 days with a range of 90 to 175 days. The importance of serving the document in a timely manner is self-evident in terms of the Agency mission to promote the safety and soundness of the System. Further, institutions have stated that the time afforded them to take corrective action is not sufficient when the next full examination follows closely behind the date of the enforcement action. The recent transfers within FCA should help to reduce the time lag between the date of the examination exit conference and the placement of the enforcement document. However, the delegation of additional authority would also help to expedite the process.

Enforcement activity has significantly declined.

The number of enforcement actions sharply declined during the period from December 31, 1989 to December 31, 1997, reflecting the tremendous improvement in the financial condition of the System. This decline is illustrated by the yearend statistics in the following.

December 31,	Number of Institutions	Total Assets Under Enforcement Actions
1989	72	$45 Billion
1990	88	$52 Billion
1991	77	$50 Billion
1992	65	$33 Billion
1993	49	$23 Billion
1994	26	$27 Billion
1995	08	$ 8 Billion
1996	06	$ 1 Billion
1997	05	$ 3 Billion

The composite CAMEL (Capital, Asset quality, Management, Earnings, and Liquidity) ratings for individual institutions for the same period also illustrate this marked improvement in the condition of System institutions. Only 8 of 208 institutions (3.8%) carried a composite CAMEL rating of "3" or lower at December 31, 1997, compared with 150 of 257 institutions (58.4%) at December 31, 1989.